

**Review of the Submitted Budget  
for Fiscal Year 2003**

March 2002

**City Auditor's Office**

**City of Kansas City, Missouri**

March 5, 2002

Honorable Mayor and Members of the City Council:

The city continues to face a structural imbalance that weakens the city's ability to provide services in the 2003 submitted budget. The city's commitment to addressing long-term neglect of capital maintenance is being tested. Absent structural changes, the imbalance will continue to weaken the city's financial condition; hurting the city's ability to provide services like police, fire, and street maintenance.

While the city has faced a structural imbalance for years, a relatively strong economy and additional revenue sources have masked its effects. The consequences of the long running structural imbalance are clearly evident in the submitted budget, which does not balance future revenue and expenditure growth, uses reserves to fund ongoing operations, and defers capital maintenance.

Expenditures have driven the structural imbalance. The city has increased spending over the past two decades without significantly reallocating resources from low to high priorities. Without reallocating resources – without structural changes – the city increased capital spending by adding new revenue sources. Short-term measures used to balance previous budgets resulted in deferred costs that the city faces now.

Our budget review also addresses the city's limited financial flexibility and sharp growth in expenditures for development incentives. Over the last decade, the city has lost financial flexibility. More and more revenues are restricted, debt service remains high, and general fund transfers to other funds have grown. Expenditures for development incentives continue to increase dramatically. The submitted budget calls for TIF and STIF expenditures of \$42 million. Six years ago, TIF and STIF expenditures were \$1 million. With such sharp growth, managing the expenditures is a challenge.

To strengthen the city's financial condition and thus its ability to provide services like police, fire and street maintenance, we recommend the Mayor and City Council appoint a citizen's committee to review the budget structure and make recommendations to achieve a stable budget structure.

We appreciate the assistance of management staff in providing information for our analysis. The team for this project was Mike Eglinski, Deborah Jenkins, Doug Jones, Amanda Noble, Joan Pu, and Julia Terenjuk.

Mark Funkhouser  
City Auditor

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# Review of the Submitted Budget for Fiscal Year 2003

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## **Review of the Submitted Budget for Fiscal Year 2003**

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## Introduction

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### Objectives

This review of the City Manager's submitted budget for fiscal year 2003 was conducted pursuant to Resolution 911385. The resolution directs the City Auditor to annually review and comment on the City Manager's budget.

This year's review focuses on the overall financial condition of the city. In particular, we look at the consequences – illustrated in this year's submitted budget – of the structural imbalance. The imbalance has been a major problem for the city for years. This year, the city dips into the fund balance and defers maintenance. Tax increases are being considered.

This is our twelfth budget review.

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### Scope and Methodology

We followed applicable government auditing standards in reviewing the submitted budget. We followed the general standards, the field work standard for supervision, and applicable reporting standards. Our methods included:

- Reviewing the City Manager's preliminary and submitted budgets.
- Reviewing adopted city budgets from 1984 through 2002, citizen and business surveys, audit reports, city ordinances, and the city's CAFRs.
- Updating analyses from prior budget reviews.
- Interviewing staff from the Office of Management and Budget.

No information was omitted from this report because it was deemed privileged or confidential.



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## Analysis

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### Financial Condition Remains a Concern

Strengthening the city's financial condition requires balancing current and future revenue and expenditure growth, maintaining an adequate fund balance, and adequately funding capital maintenance. The submitted budget fails each of these tests.

**Expenditures forecast to exceed revenues.** The City Manager's submitted budget forecasts revenues to grow by about 4 percent a year while expenditures grow by about 5.3 percent a year. The resulting shortfall is \$24.9 million in 2004 and \$36.6 million in 2005. (See Exhibit 1.)

Exhibit 1. Three Year Revenue Expenditure Comparison (in Millions)

	2003	2004	2005
Revenues	\$476.3	\$497.0	\$515.3
Net transfers	-30.4	-35.5	-39.2
Ongoing expenditures	459.3	485.2	509.6
Carryover used	13.4	0	0
Maintain 5.3 fund balance	0	1.2	1.1
Build fund balance	0	0	2
Shortfall	\$ 0	-\$ 24.9	-\$ 36.6

Source: Submitted Budget 2003.

**Reserves used to balance the budget.** To balance the 2003 budget, the City Manager proposes using a portion of the general fund balance. Doing so, would reduce the general fund balance to 5.3 percent even though city policy is to maintain an 8 percent fund balance.

**Capital maintenance is deferred.** Funding for street preservation and other deferred maintenance is well below what is needed. The city would need to spend about \$25.5 million more in 2003 to meet the needs for street preservation, building and bridge rehabilitation, and traffic signal improvements. The submitted budget does not meet the city's policy of increasing deferred maintenance expenditures by \$5 million.

The structural imbalance will be eliminated when:

- current revenue and current expenditures are in balance;
- an adequate fund balance is maintained;
- maintenance expenditures are not deferred; and
- expected revenue growth is equal or greater than the expected expenditure growth in coming years.

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## **Imbalance Weakens City's Ability to Provide Services in Submitted Budget**

The submitted budget illustrates the consequences of the city's structural imbalance. The budget does not adequately fund priorities, defers capital maintenance, and reduces the fund balance. Tax increases are being considered. These strategies, which may be appropriate short-term responses, weaken the city's ability to provide services over the long-term.

### **Priorities Not Funded**

The Mayor and City Council have identified the Community Infrastructure Committee's (CIC) recommendation to increase spending on deferred maintenance, and building and maintaining a higher fund balance as two of their priorities.<sup>1</sup> In the submitted budget, neither of these priorities is being funded at the levels the Council directed. In addition, the budget limits flexibility for the Mayor and City Council to fund other priorities that emerge during the year.

### **Capital Maintenance Further Deferred**

The submitted budget does not include an increase in funding for deferred maintenance. In fact, funding for the program is \$1 million less than last year. Deferring maintenance ultimately costs the city more money because structures can deteriorate to the point where relatively minor repairs become major (or even impossible or impracticable).

The submitted budget does not comply with the City Council policy of adding \$5 million annually to fund capital maintenance. In 1997, the City Council passed a resolution to support the CIC's recommendation to add \$5 million annually through fiscal year 2006 to fund capital maintenance projects that had been deferred through the years.<sup>2</sup>

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<sup>1</sup> Resolution 971326 and Resolution 980506.

<sup>2</sup> Resolution 971326.



The condition of the city's infrastructure is important to the public. In the 2001 citizen survey, seventy-four percent of respondents selected maintenance of city streets, buildings, and facilities as one of their top three choices for services that should receive emphasis over the next two years. Forty percent of respondents selected traffic flow as one of their top three choices.<sup>3</sup> In the 1999 business survey, respondents rated street maintenance along with police and fire services as among the most important services the city provides.<sup>4</sup>

A comprehensive inventory of assets would be required to determine precisely how much would be needed to fund all deferred capital maintenance. However, Public Works staff estimates that annual expenditures for street preservation and marking, municipal building rehabilitation, bridge rehabilitation, and traffic signal safety would need to be nearly doubled to adequately address the need.<sup>5</sup> According to their estimates, approximately \$26 million in additional funding would be needed to bring spending up to the estimated amount needed this year. (See Exhibit 2.)

Exhibit 2. Submitted Deferred Maintenance Expenditures Compared to Annual Need (in Millions)

Project	Submitted Budget	Estimated Need
Street preservation and marking	\$ 8.6	\$20.0
Municipal building rehabilitation	8.4	16.0
Bridge rehabilitation	6.5	10.0
Traffic signal safety improvement	3.8	7.0
Total	\$27.3	\$53.0

Sources: Submitted Budget 2003 and Public Works Department.

### The City Needs to Improve Streets

Citizen dissatisfaction with street maintenance is growing. When surveyed about a variety of city services, citizens were least satisfied with street maintenance and satisfaction is declining. Fifty-three percent of respondents in 2001 rated their satisfaction as a 1 or a 2 on a 5-point scale, where 1 means very dissatisfied, compared to forty-seven percent of the respondents in the 2000 survey. Forty-three percent of

<sup>3</sup> *City Services Performance Report for Fiscal Year 2001*, Office of the City Auditor, Kansas City, Missouri, forthcoming.

<sup>4</sup> *1999 Survey of Kansas City Businesses*, Office of the City Auditor, Kansas City, Missouri, February 2000, p. 7.

<sup>5</sup> The amount used for building rehabilitation is 2 percent of replacement value. The bridge rehabilitation amount is based on the biennial bridge inspection report. The Public Works Department calculates approximate costs for street preservation and traffic signal safety improvement.

respondents rated their satisfaction with the maintenance of streets in their neighborhoods as a 1 or 2 in 2001.

Owners and managers of businesses located in the city also rated street maintenance as an important city service, and the quality of streets as low. About 45 percent of respondents of the 1999 business survey selected street maintenance as one of the three city services most important to their businesses. About 40 percent of the respondents rated street maintenance in Kansas City as poor or below average.

Business owners and managers identified several important aspects of street maintenance affecting their businesses in business focus group interviews conducted in October 2001, including road surface conditions, quick street repairs, street cleanliness, and bridge conditions.<sup>6</sup>

Street cracks are a major problem in city streets. The Street Maintenance Assessment Survey conducted by the Public Works Department in 2001 indicated that 40 percent of asphalt streets citywide had crack problems. The goal is for no more than 30 percent of the streets to have crack problems.

### **Fund Balance Decreases**

In the submitted budget, the fund balance is reduced from 8 percent (about \$28.5 million in fiscal year 2002) to 5.3 percent (about \$18.9 million) of general fund expenditures. The reduction results from spending approximately \$8.6 million from the fund balance to finance programs in fiscal year 2003.

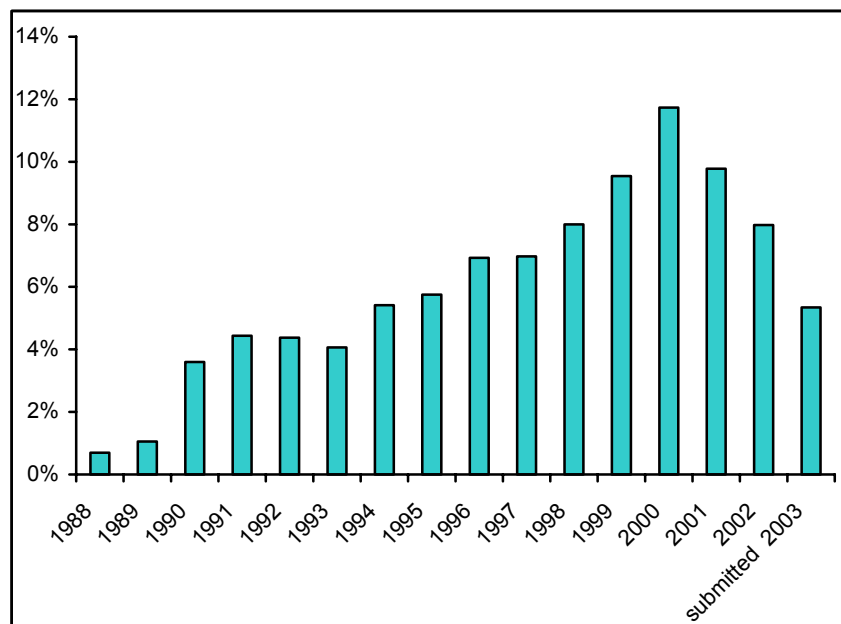
The long-term structural imbalance and decreasing fund balance diminish the city's ability to respond to unexpected emergencies. The fund balance provides a financial cushion in the event of the loss or decline of a revenue source, economic downturns, unanticipated emergencies such as natural disasters, and uneven cash flow. During an economic downturn the fund balance allows the city to buy time for planning and implementing cost containment measures.

**Rebuilding the fund balance is a priority.** The City Manager said in his budget transmittal letter that restoring the fund balance should be a priority as revenues improve. The City Manager and elected officials should ensure that the reliance on the fund balance does not continue and that rebuilding it is a priority. During the past 15 years, the city has successfully increased the fund balance from 0.7 percent of general fund expenditures to more than 8 percent. (See Exhibit 3.)

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<sup>6</sup> 2001 Business Focus Group Report, Office of the City Auditor, Kansas City, Missouri, forthcoming.

Exhibit 3. General Fund Balance As a Percent of Expenditures



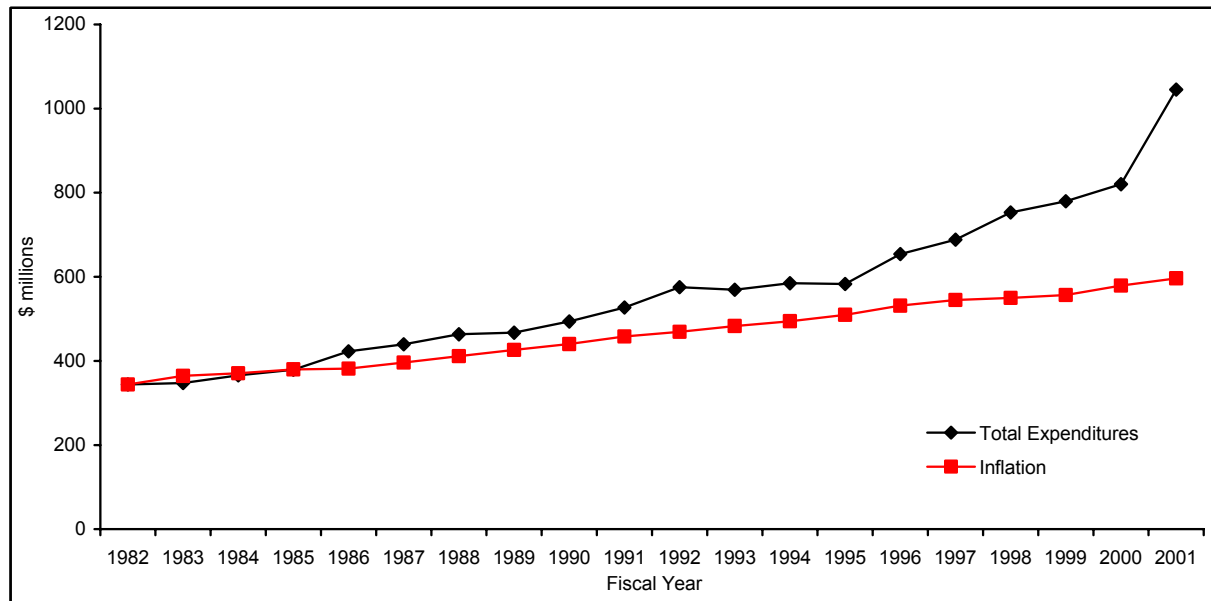
Sources: Adopted Budgets 1989-2002 and Submitted Budget 2003.

## Expenditures Drive the Imbalance

Over the last two decades, expenditures and revenues have grown substantially. Rather than shift money from low to high priorities, the city has used new revenues to address priorities, add and expand programs, and retain programs previously funded through federal revenue sharing. The city addressed previous shortfalls with short-term measures that have increased costs now and in the future. Years of deferred maintenance have created a substantial backlog. Lack of investment in personnel and technology in the late 80s through the mid-90s also created costs that the city faces now.

**Expenditure increases outpaced inflation.** Between fiscal years 1982 and 2000, expenditures increased about 42 percent, adjusted for inflation. Expenditures on capital and debt service have increased relative to other expenditures. Operating expenditures made up about 71 percent of the budget in fiscal year 1982 and 65 percent of the budget in fiscal year 2000. Personal services (wages, salaries, overtime, etc.) have been about 55 percent of operating costs. Total expenditures increased sharply in fiscal year 2001 with an additional \$85 million in Aviation capital expenditures, \$36 million for Liberty Memorial renovation and expansion, and \$49 million to refund two bond issues. (See Exhibit 4.)

Exhibit 4. Total Expenditures All Funds, Fiscal Years 1982-2001



Sources: Adopted Budgets 1984-2002 and Submitted Budget 2003.

**New revenues have supported increased spending on capital.** The city has increased funding for capital improvements using new revenue sources. These revenues – including sales tax, use tax, and gaming – accounted for \$107 million in fiscal year 2001. (See Exhibit 8 on page 13 for a timeline of new revenues.)

Voters first authorized a sales tax for capital in August 1983. The one-cent tax became effective in January 1984 and shows up in the fiscal year 1985 budget – half was used for capital improvements and half was used for assistance to school districts. Prior to this time, the city had two one-half cent sales taxes used for assistance to schools and public mass transportation. A portion of the mass transportation tax was also used for street maintenance. Voters authorized a one cent sales tax in 1988 (renewing the existing tax) to support school districts and capital.

Despite the renewed sales tax for capital improvements in 1988, general municipal spending on capital dropped after the loss of federal revenue sharing in fiscal year 1988. Spending on capital improvements excluding enterprise funds was \$35 to \$40 million each year between 1988 and 1994. Spending increased in 1995 when the portion of sales tax devoted to school assistance expired and was shifted to capital. Spending on capital again increased in the late 1990s with the addition of gaming revenues and local use taxes. Spending increased sharply in 2001 with the Liberty Memorial renovation and expansion project, which is mostly funded through a one-half cent sales tax that was collected for

18 months between April 1999 and September 2000. Voters approved an additional quarter cent sales tax to be collected for 15 years starting January 1, 2002, to fund Fire Department capital improvements and hire additional firefighters.

While capital improvement spending has increased as a percent of the general municipal budget, spending remains below the 20 percent goal, which the Community Infrastructure Committee recommended and City Council adopted in 1997.<sup>7</sup> (See Exhibit 5.)

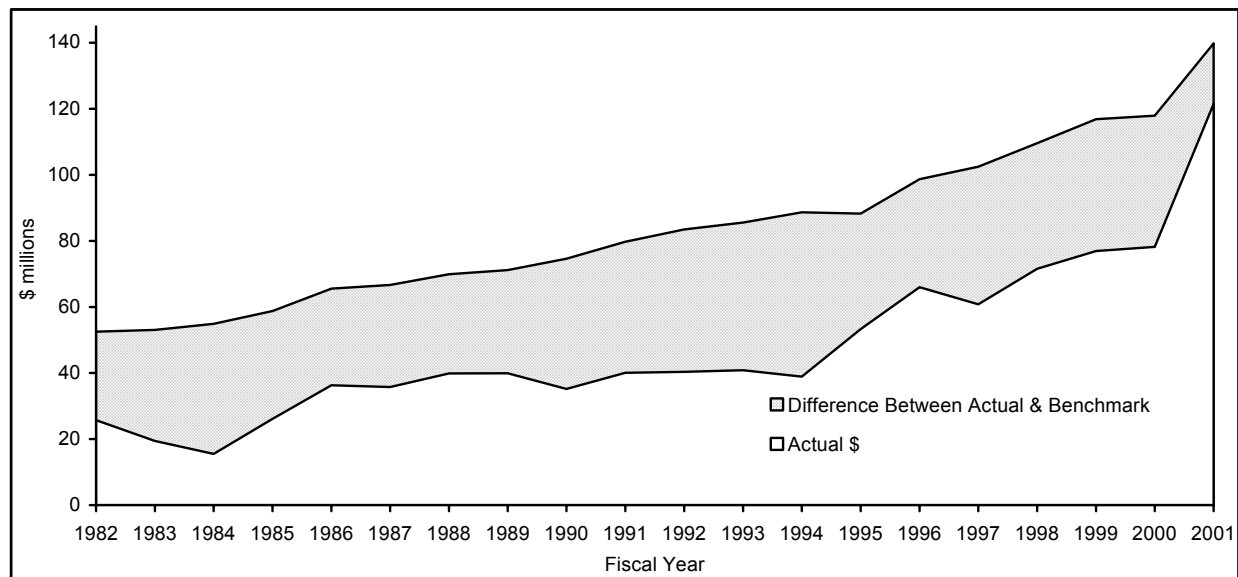
Exhibit 5. Capital Improvement Spending (in \$ Millions) Excluding Enterprise Funds FY 1982-2001

Fiscal Year	General Municipal Expenditures	Capital Improvement Expenditures	Percent	Difference Between Spending and 20% Benchmark	Cumulative Difference
1982	262.6	25.7	9.8%	(26.8)	(26.8)
1983	265.3	19.5	7.3%	(33.6)	(60.4)
1984	274.5	15.5	5.7%	(39.4)	(99.8)
1985	293.9	26.2	8.9%	(32.6)	(132.4)
1986	328.0	36.3	11.1%	(29.3)	(161.7)
1987	333.2	35.8	10.7%	(30.9)	(192.6)
1988	349.7	39.9	11.4%	(30.0)	(222.6)
1989	356.1	39.9	11.2%	(31.3)	(253.9)
1990	373.2	35.2	9.4%	(39.5)	(293.3)
1991	398.9	40.1	10.1%	(39.7)	(333.0)
1992	417.4	40.4	9.7%	(43.1)	(376.1)
1993	428.1	40.8	9.5%	(44.8)	(420.8)
1994	443.4	38.9	8.8%	(49.7)	(470.6)
1995	441.4	53.3	12.1%	(35.0)	(505.6)
1996	493.6	66.0	13.4%	(32.7)	(538.3)
1997	512.3	60.8	11.9%	(41.6)	(579.9)
1998	547.9	71.6	13.1%	(38.0)	(617.9)
1999	584.3	77.0	13.2%	(39.9)	(657.8)
2000	589.7	78.3	13.3%	(39.7)	(697.5)
2001	699.2	121.5	17.4%	(18.3)	(715.8)

Sources: Adopted Budgets 1984-2002 and Submitted Budget 2003.

<sup>7</sup> Second Committee Substitute for Resolution 971326.

Exhibit 6. Difference Between Capital Spending and Benchmark, General Municipal Funds, FY 1982-2001



Sources: Adopted Budgets 1984-2002 and Submitted Budget 2003.

**New revenues have also supported new or expanded programs.** In 1989, voters approved an increased property tax levy from (\$0.23 to \$0.50 per \$100.00 assessed valuation) for health care and an increased cigarette tax of 5 cents per pack to fund operating a hazardous materials team. In 1990, voters approved increasing property taxes for zoo expansion, and hotel/motel and restaurant taxes to expand Bartle Hall. Hotel/motel taxes were increased again in 2000 to support and promote tourism. In 1992, voters replaced the city sticker fee with a uniform vehicle license fee of \$12.50 for each motor vehicle to fund parks maintenance, and construction, renovation and operation of community centers.

**Responses to previous economic downturns and loss of federal funds focused on short-term.** After federal revenue sharing was discontinued in fiscal year 1988 and during the economic downturn in the early 1990s, the city balanced annual budgets by drawing down fund balance, deferring maintenance, cutting vacant positions, freezing salaries, not budgeting for expected costs such as utility bills and health insurance premium increases, and relying on one time revenues to cover ongoing operating expenses. These short-term measures contributed to a backlog of maintenance, problems with compensation, out-dated technology, and low fund balances – pushing costs to future years. In recent years, the city increased its general fund balance, made changes in compensation, and started investing more in technology. Addressing these costs now has put additional pressure on the city's budget so expenditures continue to grow faster than revenues.

**The city is paying now.** Despite greater than expected revenue growth over the past few years, balancing the budget in this downturn has been difficult. The City Manager has frozen hiring for all but public safety positions, frozen travel, and asked departments to cut expenditures in other ways. However, revenues have exceeded estimates in the past few years. (See Exhibit 7.) Between 1997 and 2001, the city took in about \$134 million more than was budgeted in general municipal funds. Much of the difference was in new revenue sources – gaming and local use tax. The city budgeted \$677.3 million general municipal revenue in the current fiscal year and was projecting a shortfall of about \$17 million in the general municipal funds at the second quarterly analysis (November 2001), about 2.5 percent of general municipal funds.

Exhibit 7. Difference Between Actual and Budgeted Revenues (\$ Millions), General Municipal Funds, Fiscal Years 1997-2001

Revenue	1997	1998	1999	2000	2001
Actual	521.5	558.6	598.1	659.2	685.3
Budgeted	505.3	535.9	572.9	628.6	645.9
Difference	16.2	22.8	25.2	30.7	39.4
Percent Difference	3.1%	4.1%	4.2%	4.7%	5.8%

Sources: Adopted Budgets 2000-2002 and Submitted Budget 2003.

**Continuing to add new revenues without containing expenses is not a long-term solution.** To address the imbalance, the City Manager and elected officials must address expenditure growth by reducing or eliminating funding for lower priority programs. In this way, the city could reallocate spending to higher priorities without continuing to seek new revenue sources. Kansas City's overall tax effort is relatively high compared to other local governments in the metropolitan area.<sup>8</sup> Continuing to increase taxes to address priorities may influence people's decision about where to live, work or locate businesses.

We recommend the Mayor and City Council appoint a citizen's committee to review the budget structure to make recommendations to achieve a stable budget structure. Once the imbalance is addressed, target-based budgeting would build-in more discretion for reallocating funds on a yearly basis. We recommended in our August 2001 *Special Report: Budget Process Practices* that the City Manager adopt target based budgeting.<sup>9</sup> In this method of budgeting, elected officials are

<sup>8</sup> *Comparative Analysis of Tax Effort Special Report*, Office of the City Auditor, Kansas City, Missouri, October 2000, p. 7.

<sup>9</sup> This approach was recommended by Irene S. Rubin, Ph.D., a professor of Public Administration and Political Science at Northern Illinois University who has specialized in the study of municipal government and the appropriate budgetary role for elected officials in the council-manager form of government. We consulted with Professor Rubin while conducting our special report on the city's budgeting practices.

involved at the outset by developing specific goals. The City Manager then sets a target budget for each department based on revenue projections such that the total budget is below projected revenue by a certain percent. The remainder provides funds for the Mayor and Council to allocate to meet specific goals.

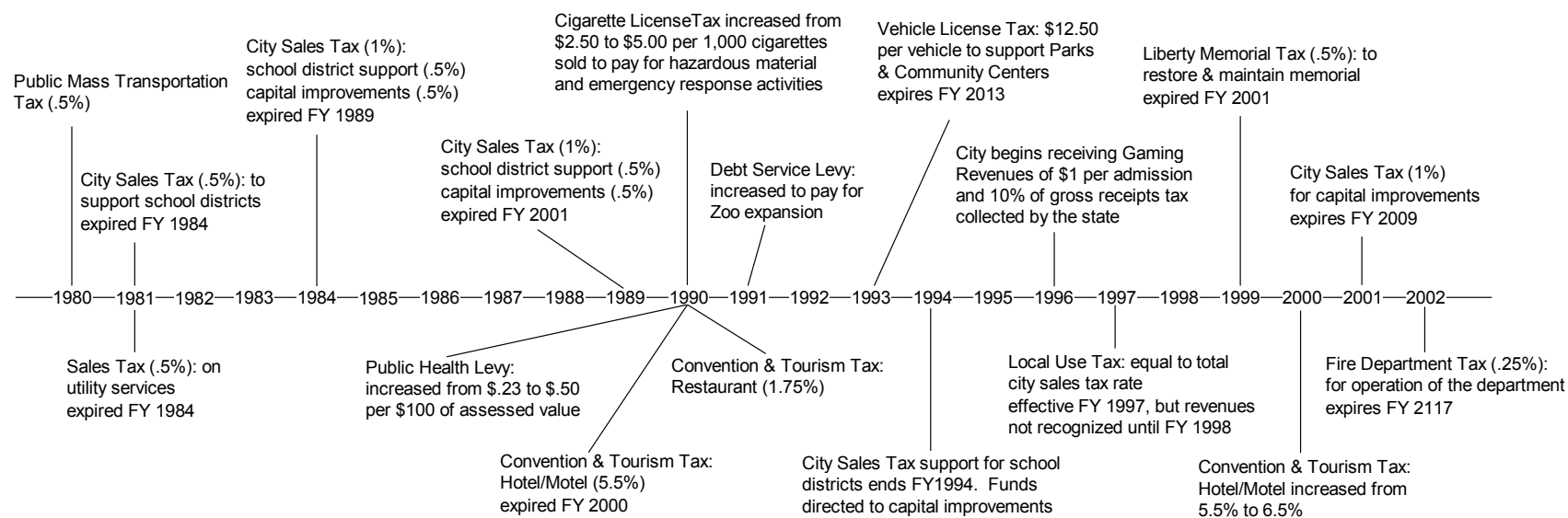
#### **How Target-Based Budgeting Works**

- Working with the City Manager, elected officials develop specific goals and priorities that are tied to a long-range strategic plan.
- The Office of Management and Budget projects revenue for the upcoming year.
- The City Manager sets a target budget amount for each department. The total budget amount is set below expected revenue, creating a pool of unallocated funds.
- Department managers develop budget requests by relating expenditures to city goals and priorities, and by prioritizing expenditures within the maximum target budget levels.
- Department managers develop a prioritized list of the unfunded items that were squeezed out by the target. Consequences of leaving items unfunded and justifications for potential new, but unfunded projects are also submitted.
- The Office of Management and Budget reviews budget proposals for compliance with targets and technical guidance.
- The Office of Management and Budget examines the unfunded lists submitted by the departments and the potential consequences of leaving them unfunded. Unacceptable cuts are returned to departments for revision.
- The departments' unfunded lists are combined and then ranked based upon elected officials' priorities to create a citywide list. Items are funded as far down the list as resources allow.

Source: *Special Report: Budget Process Practices*, Office of the City Auditor, Kansas City, Missouri, August 2001, p 16.



## Exhibit 8. New Revenue by Effective Date



Sources: Revised Statutes of Missouri; Kansas City, Missouri Ordinances; and Comprehensive Annual Financial Reports, 1980-2001.

## **Financial Flexibility Remains a Concern**

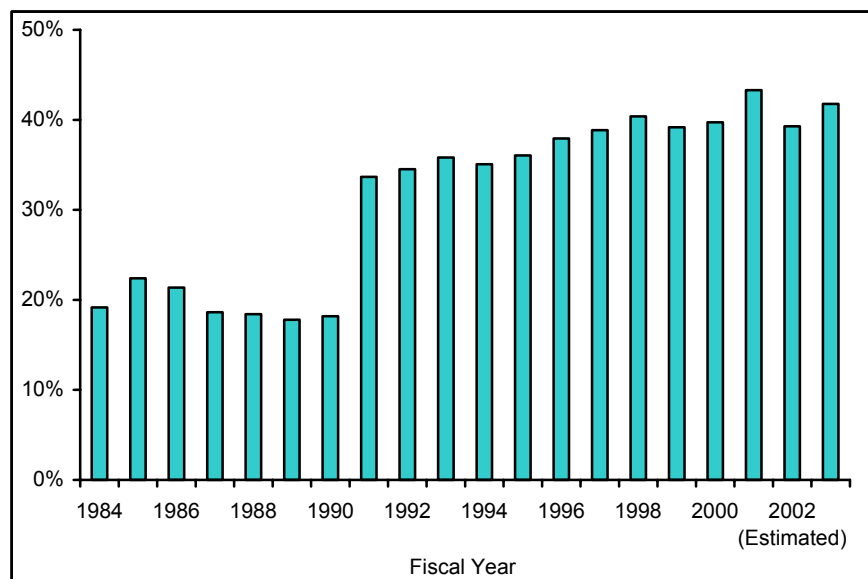
The city's financial flexibility is restricted, reducing the ability of the Mayor and City Council to address future priorities or respond to unforeseen problems. Restricted revenues represent a large and increasing portion of operating revenues. General fund transfers remain high compared to the early 1990s. These trends raise concerns about the city's future financial flexibility.

### **Financial Flexibility Is Limited**

The city's financial flexibility has not improved. The proportion of the city's operating revenue that is restricted in use remains high, limiting the ability of the Mayor and City Council to alter spending priorities in response to changing needs. Continuing increases in debt service reduce flexibility in the short term by allocating funds to repayments and in the longer term by reducing the city's capacity to borrow for additional needs. Increased general fund transfers also pose a threat to financial flexibility; when dedicated revenues do not keep pace with the cost of the programs they are intended to provide, there is more pressure on the general fund to support these services.

**About 40 percent of operating revenues are restricted.** Restricted revenues increased from 18 percent of operating revenues in fiscal year 1990 to a budgeted 42 percent in fiscal year 2003. (See Exhibit 9.) Restricted revenues are earmarked for specific uses by state law, bond covenants, city ordinances, or grant requirements. As a growing proportion of revenues is restricted, the Mayor and City Council have less flexibility to respond to changing priorities and unforeseen conditions.

Exhibit 9. Restricted Revenues as a Percent of Operating Revenues



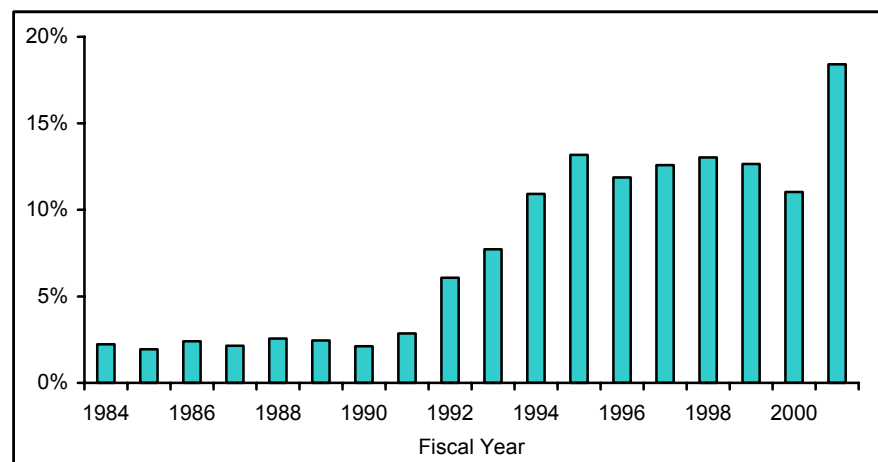
Sources: Adopted Budgets 1984-2000 and Submitted Budget 2003.

**Debt service remains high.** Debt service as a percent of operating revenue began increasing in fiscal year 1991. In 2001, debt service increased to 18 percent of operating revenues. Most of the increase was due to refunding bonds.<sup>10</sup> Although debt service remains below the 20 percent warning level, it has been above the 10 percent level considered acceptable by financial experts since fiscal year 1994.<sup>11</sup> (See Exhibit 10.) A high level of debt service limits short-term financial flexibility and reduces borrowing capacity in the longer term.

<sup>10</sup> The increase in debt service expenditures for 2001 is mostly due to refunding \$29 million in Public Safety and Zoo Improvements Bonds and retiring \$20.3 million in Special Obligation Revenue Bonds.

<sup>11</sup> *Evaluating Financial Condition: A Handbook for Local Government* (Washington, D.C: ICMA, 1994), p. 88.

Exhibit 10. Debt Service as a Percent of Operating Revenues



Sources: Comprehensive Annual Financial Reports, 1984-2001.

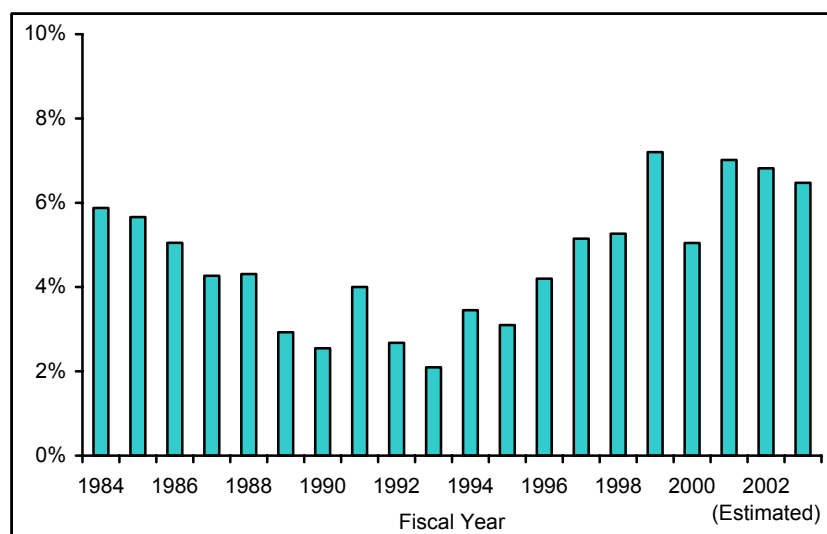
Although debt service expenditures seem high, the city is in line with the debt limit recommended by the Community Infrastructure Committee.<sup>12</sup> As of December 2001, the city's debt score was 112, below the city's target cap of 120.<sup>13</sup>

**General fund transfers remain high.** Since 1993, transfers from the general fund have increased almost every year. Net transfers out are budgeted to be about \$26 million in fiscal year 2003. (See Exhibit 11.) Funds for development incentives and Parks and Recreation Department programs accounted for the bulk of the transfers. In some cases, new revenues do not cover the operating costs they are intended to fund. For example, part of the vehicle license tax revenue was to pay for the operating costs of the community centers. In fiscal year 2001, vehicle license revenue and fee revenue combined covered about 77 percent of the community centers' operating costs with the general fund making up the difference. Increasing general fund transfers reduce financial flexibility, as dedicated revenues do not keep pace with the cost of providing the programs they are intended to provide.

<sup>12</sup> "Closing the Gap", *A New Focus on Capital Improvements*, Community Infrastructure Committee, 1997, pp. 12-17.

<sup>13</sup> The Community Infrastructure Committee's debt score is an average of three financial ratios - debt per capita, debt as a percent of market value, and debt as a percent of general municipal expenditures. The Community Infrastructure Committee recommended establishing a cap for debt service. The committee proposed a cap of 120 percent for fiscal years 2002 through 2006 and a cap of 110 percent by fiscal year 2007.

Exhibit 11. Net General Fund Transfers Out as a Percent of the General Fund



Sources: Adopted Budgets 1984-2000 and Submitted Budget 2003.

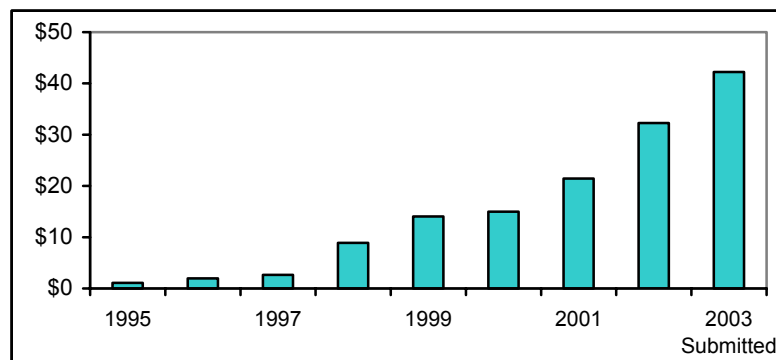
## Managing Development Incentives Is a Growing Financial Challenge

Managing development incentives, such as tax increment financing (TIF) and Super TIF, is a growing financial challenge. TIF and Super TIF expenditures have increased and will continue to grow in the coming years. Although the long-term revenue effects of funding development through incentives are not known, the size and sharp growth in the use of incentives reduces the city's financial flexibility. The city has not adopted policies to address the use of TIF. Risks associated with the use of TIF, identified in prior audit work, warrant attention and careful management of development incentives.

### TIF Expenditures Continue to Grow

Expenditures for TIF projects have grown dramatically in the past six years and continued growth is forecasted. In fiscal year 1995 TIF expenditures totaled \$1.1 million; they are expected to grow to an estimated \$42.2 million in fiscal year 2003. (See Exhibit 12.)

Exhibit 12. Annual TIF and Super TIF Expenditures, (\$ Millions), FY 1995-2003



Sources: Adopted Budget 2002 and Office of Management & Budget; Submitted Budget 2003. (2002 is estimated and 2003 is proposed.)

### **TIF Growth Reduces Financial Flexibility; Long-term Revenue Effects Unknown**

The growth in incentive expenditures reduces the city's financial flexibility. Inter-fund transfers to TIF and Super TIF funds have increased. The portion of transfers-out from the general fund to TIF funds has also been growing. However, the long-term effects to city revenue streams are not clear.

### **The financial information report examining the relationship between TIF and the corresponding revenues provides no definitive answer.**

The Finance Department submitted the first annual report examining the effects of the city's economic development incentive programs on the budget. The report tracks TIF revenues and expenditures, debt level, economic impact, and tax base.

The report emphasizes the difficulty of estimating the effect of the economic incentives. "Overall, it poses more questions than it answers and highlights the needs for better tracking of economic incentive data, additional research on subjects like the possible substitution effect and further examination of the cumulative effects of plan approval."<sup>14</sup>

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<sup>14</sup> *Aggregate Incentive Data Report*, Finance Department, City of Kansas City, Missouri, October 2001, p. IV.

### **Risks Associated with Development Incentives Warrant Careful Management**

The city has not adopted policies to address the use of development incentives.<sup>15</sup> TIF is a substantial – and fast growing – city expenditure, and the risks associated with it warrant strong accountability to achieve public goals. Among the risks are:

- TIF could be used when it is not necessary. It can be in the interest of developers to seek TIF even in those cases where a proposed project is economically feasible without a public subsidy.<sup>16</sup> The lack of a formal city policy and the history of the use of TIF being driven by developers increase the likelihood that TIF will be used when it is not necessary.
- TIF projects could perform below expectations. In 1998 we found TIF plans were generating less revenue than projected in the plans. This is of particular concern if important public goals, such as eliminating blight, are not addressed as anticipated.<sup>17</sup> It is also especially important if TIF revenues are supporting debt because other public revenues may be required to support the debt.<sup>18</sup>
- Economic activity taxes that would otherwise be available to the city could be “captured” by the redevelopment. Revenues can be “captured” when sales or earnings that occurred in other parts of the city move to TIF areas.<sup>19</sup> This phenomenon is sometimes referred to as the “substitution effect.”
- TIF can change the locations in which development occurs in ways that reduce growth. TIF might help growth within a district, but hurt growth outside the district by a greater amount.<sup>20</sup>

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<sup>15</sup> Resolution 010924, establishing a policy for the use of TIF, was introduced to the Finance and Audit Committee on June 14, 2001. It was held off the agenda on November 7, 2001. The resolution will appear on the semiannual docket in May of 2002.

<sup>16</sup> *Performance Audit: Tax Increment Financing*, Office of the City Auditor, City of Kansas City, Missouri, September 1998, p. 5.

<sup>17</sup> *Performance Audit: Tax Increment Financing*, pp. 16-20.

<sup>18</sup> The Finance Department recently presented information that showed the Uptown Theatre revenues, which are supporting debt, are far below original projections. As a result, the project will require subsidies from the general fund and state tax credits in order to meet debt requirements.

<sup>19</sup> *Review of the Submitted Budget For Fiscal Year 2000*, Office of the City Auditor, Kansas City, Missouri, March 1999, pp. 29-30.

<sup>20</sup> Richard F. Dye and David F. Merriman, *The Effects of Tax Increment Financing on Economic Development*, Working Paper #75, (Institute of Government and Public Affairs, University of Illinois, September 1999), p. 22.

- TIF could negatively effect the local government's financial condition.<sup>21</sup>

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<sup>21</sup> Kenneth Kriz, "The Effect of Tax Increment Finance on Local Government Financial Condition," *Municipal Finance Journal*, Spring 2001, pp. 41-64.